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REFLECTION ON THE RURAL FINANCIAL MARKETS CONFERENCE HELD AT WYE COLLEGE

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The Wye Conference was one of a series of meetings on rural finance that The Ohio State University, with support from the Agency for International Development, has recently held in various countries. The meetings have been prompted by the increasing attention given to credit programs aimed at stimulating agricultural production and helping the rural poor in low income countries. The popularity of these credit activities is due, in part, to the ease with which most of them can be carried out. For the political leader it is easy to announce a new credit program or to increase the amount of funds available for lending in response to some pressing problems in rural areas; a credit response allows the government to show an immediate concern for problems. Other reasons for the popularity of credit programs are traditional feelings that informal credit markets are working poorly, that many farmers have a desparate need for additional loans, and that most farmers will not adopt profitable new technology unless they have access to formal loans. Many of these traditional feelings about rural financial markets were challenged by papers and discussions in the Conference.

The topics covered in the Conference fell into three general groups: policy issues that affect the overall performance of rural financial markets, problems faced by the financial intermediary, and financial problems in farm households.

Policy Issues

Three Conference papers focused on how national policies affect the performance of rural financial markets [Adams, Giorgis, and Graham and Bourne]. I argued that many of the agricultural credit programs around the world were not working well and that the overall performance of rural financial markets was unsatisfactory. This is due to incorrect policies based on faulty assumptions. Concessionary interest rate policies and the failure to use formal rural financial markets to mobilize voluntary financial savings were two of the points I emphasized.

The papers on Ethiopia and Jamaica illustrated some of the common problems that persist in rural financial markets in low income countries. Ethiopia is typical of many African countries that have relatively small formal financial systems and few formal rural financial institutions. In countries like Ethiopia, building and strengthening the financial institutions that provide financial services must receive a good deal of attention. This includes experimenting with various credit delivery systems. Specialized public agricultural credit agencies, cooperatives, pressure on commercial banks to extend their services in rural areas, loans to informal groups of farmers, and tying of credit to area development programs are part of building this financial infrastructure. Loan repayment problems, weak financial institutions, lack of medium and long-term credit, resistance by commercial banks to agricultural lending in general and to small farmers in particular, and political intervention in rural financial markets are typical problems that emerge in countries like Ethiopia. It is also common that providing loans to small farmers is more expensive than anticipated. The willingness of foreign aid agencies or local governments to sustain the subsidies needed to maintain financially viable formal lenders tends to weaken as the costs of the program become visible.

A number of countries also experience the same type of problems faced in Jamaica: e.g. Turkey, Guyana, Peru and Bangladesh. In these countries the financial infrastructure is reasonably well developed, but the level of real economic activity and economic stability in the country is such that it is very difficult to maintain a healthy and viable financial system. Countries like Jamaica that are experiencing negative real economic growth rates present special problems for those interested in rural finance. If farmers find that their product prices are relatively low, that many of the modern inputs they need are in short supply, that marketing conditions are chaotic, and that little or no new agricultural technology is available to them, they will realize low returns to loan use in agriculture. This leads to a slack in loan demand and/or severe loan repayment problems. This in turn ties up a good deal of the lender's managerial time and causes staff morale problems. Political interventions are common in this environment as the government tries to expand the supply of loans as a means of overcoming deficiencies in real economic activities.

The Jamaican case is a vivid reminder that increasing the amount of concessionary priced loans is not a substitute for economic policies that result in high yields or product prices at the farm level. The Jamaican case also illustrates the problems of maintaining strong financial institutions that have capable staffs, collect most of their loans, have operations that cover their costs, develop a loan portfolio that matches the term structure of its sources of funds, and is also able to maintain some independence from political interference.

Financial Intermediaries

Nine of the conference papers discussed various problems of financial intermediaries providing financial services in rural areas [Von Pischke, Wilson, D'Mello, Youngjohns, Roberts, Harriss, Howell and Bottrall, Verghagen, and Dridi]. One of the things that dawned on me during the discussion of these papers was that many people still feel that there is some unique financial institution that can and will provide adequate financial services in rural areas. The quest for this unique institution is eternal. Those interested in cooperatives often argue that they are the proper vehicle to provide financial services in rural areas. Others argue that only government agencies, be they development banks, commercial banks, specialized small farmer development programs with credit included, or supervised credit agencies can provide the proper services. In most of these discussions the role of the informal lender is ignored, or it is assumed that informal lenders do not provide legitimate service, and that they should be driven from the rural scene by expanding formal financial services.

For some time I have thought that this emphasis on finding the unique financial institution placed the emphasis in the wrong place. Despite a good deal of confusion about the subject, financial intermediation is a simple process that involves an intermediary taking claims on real resources from one individual or institution and lending these claims to some individual or agency that has too few resources for available opportunities. This transfer of contracts that represent claims on real resources can be done in a variety of ways. The critical aspect of this transfer is not the institutional form of the intermediary, whether the intermediary is formal or informal, or whether it is privately owned or state owned. Rather, the vital issue is the cost of financial intermediation, the dependability and stability of the lender, and whether the intermediary is providing the appropriate range of financial service to the people who need them. I feel that more emphasis ought to be placed on improving the process of financial intermediation, and that any type of intermediary that can provide the range of services needed should be supported and encouraged.

This is not to say that developing appropriate financial institutions in rural areas should be ignored. My feeling is that more time ought to be spent on determining why existing institutions, be they formal or informal, are not providing the kinds of financial services that are necessary to meet development objectives. Without this type of diagnosis, new institutions soon begin to perform like old institutions.

The papers by Von Pischke and Dridi illustrated a number of the problems that financial institutions trying to specialize in agricultural loans encounter. They both illustrated how high costs of serving agriculture in general, and the small farmer in particular, can undermine the financial integrity of the lending institution. This leads to political dependence on the part of the lending institution as it continually returns to the government or some outside aid agency for resources to maintain or expand its loanable funds and cover its operating cost. Delays in extending loans, limited outreach of the program, and centralized loan decision-making become common fare in these types of specialized agricultural credit agencies, when their interest charges and loan repayment are not sufficient to sustain the real value of the loan portfolio, or to cover the real cost of carrying out the financial intermediation.

The papers by Wilson and D'Mello reviewed some of the problems faced by commercial banks as they try, or are forced, to add more agricultural loans to their portfolio. These commercial banks face many of the same problems encountered by the specialized banks. They have some advantages, however. One is that they are able to depend more on deposits for loanable funds than is typical of specialized agricultural banks. This allows them to be a bit more independent, even if they are part of a nationalized banking system such as exists in India. They also generally have a large part of their loans extended to other sectors of the economy where the rates of return on loans are higher than they are on agricultural loans, where the loan transaction costs are generally lower than they are for agricultural loans, and where collateral is more satisfactory to the bank than is true on agricultural loans. These banks may be forced to lend to agriculture at concessionary rates, and end up loosing money on these operations, but these losses do not threaten the long-run viability of the bank as is the case for many of the specialized agricultural banks.

Several of the papers in the Conference reviewed some of the common techniques used by the monetary authorities to force commercial banks to lend more money for agricultural purposes. These techniques include loan quotas, loan guarantee programs, special rediscount facilities at central banks, forcing the banks to open more branches in rural areas, and raw political pressure. It is typically very difficult to evaluate the results of these techniques. Money and loans are fungible and divisible. It is very easy for the lenders (as well as borrowers) to appear to be responding positively to the policy intent behind these techniques, but end up making very little change in the way they do business, if it is not in their interest to change in the desired directions. They may, for example, give multiple small loans to a wealthy borrower. Very extensive data on all sources and uses of liquidity are needed to effectively evaluate the results of credit control techniques.

Youngjohns' paper showed that cooperatives encounter many of the same problems as specialized or commercial banks when they try to provide financial services in rural areas. He stressed something that is often forgotten about cooperatives; they are a business. Too many people blame the collapse of a cooperative on corrupt management or the lack of understanding of cooperative principles by management and members. Too few people explain cooperative failures on the basis of business failure. Cooperatives often fail because they cannot generate enough revenue to cover their costs of operation, and/or their services are so poor that few members want to do business with them. When policymakers try to use cooperatives as conduits for channelling cheap credit into rural areas, the local elites often capture control of the cooperative to monopolize the "sweet money" given out by the government. Since it is government money it is little wonder that the local elite, who make the loans to themselves, feel little pressure to repay the loans. It is also little wonder that a large number of the less fortunate farmers who are excluded from getting the cheap loans and enjoying the fruits of unpunished default become disaffected with doing business with the cooperative.

Several additional papers in the conference covered problems of improving the quality of the services provided by credit agencies and how to reduce their costs. Verhagen covered the general principles of forming groups. A number of countries are experimenting with group loans as a way of reducing the costs of serving small farmers. To date, the results of these group loans appears to be mixed. Some programs are working well while others are not. One of the problems associated with group lending is repayment. Many of the group loans are made on the basis of joint liability. It appears that when groups are formed solely for the purpose of getting access to loans, that the joint liability is not very effective in inducing repayment. If one member does not repay, the other members may decide not to repay. On the other hand, when a group is joined in order to realize other group "goods" beyond loans, it appears that the groups tend to hang together better.

Howell and Bottrall discussed some of the other services that might be provided along with credit. This discussion opened up the vital topic of the kinds of changes in real economic activities that must be made in order to create an environment in which additional financial intermediation is useful. Farmers will not borrow and repay loans if they cannot get a decent price most of the time for their products, if modern inputs are not generally available at reasonable prices, and if they cannot expect to get a decent yield from their farm enterprises under usual conditions. They forcefully pointed out that it may be necessary to develop administrative capacity to carry out a number of development activities before or along with loans to ensure success of the credit activities. Roberts complemented their discussion by pointing out that many credit agencies need to do staff training in order for the agency to handle the difficult tasks of lending to agriculture and also coordinate lending activities with other development efforts. He went on to argue that many of these agencies need to develop some internal evaluation capacity that can provide management with information needed for timely decision-making.

On a number of occasions during the Conference, comments were made about informal lenders. Only one of the papers, by Harriss, focused entirely on that topic, however. She pointed out something that is often overlooked in discussions about informal lenders. That is, that their lending activities, especially in low income areas are often tied up with a number of other marketing activities: product sales, input sales, exchange of labor, and information services. She argued that it is difficult to understand informal credit transactions unless one also understands the other closely related marketing activities. Overall, she also argued that the informal lenders, at least in Southern India, were generally providing valuable services that were not available from the formal financial system. Some follow-up discussion in the Conference focused on how formal lenders could learn how to improve the quality of their financial services by having a clearer understanding of what informal lenders were doing. The speed with which informal lenders make most loans is a case in point.

Farm Household Problems

Four additional papers in the Conference focused on finance problems at the farm-household level. Papers by David and Meyer and another by Lipton outlined the problems encountered when one tries to evaluate the impact of credit use at the farm-household level. Both papers stressed the complexities of engaging in this type of analysis. They stressed that liquidity uses in both the farm enterprises as well as the household must be analyzed together, and that all sources of liquidity, not just formal loans, must be looked at to get a complete picture of the impact of credit use. Again, the essential property of finance, fungibility, was fingered as the major contributor to the difficulties of analyzing what borrowers do with their loans. Without very detailed information that is very costly to collect, it is virtually impossible to directly link credit use with various types of economic changes.

Two additional papers reported on credit use activities at the farm level in Nigeria and Upper Volta. The paper by Stickley and Tapsoba discussed various measures of loan delinquency and also presented some of the main reasons for loan repayment problems at the borrower level in Upper Volta. They pointed out that shortcomings on the part of the lender were an important factor that caused default. Osuntogun's paper reported on farm level data collected in Nigeria on credit sources and uses. It stressed the need to collect this type of information so that policymakers could make more intelligent decisions about rural financial service needs. He pointed out that many borrowers used agricultural loans to pay health and education expenses. It is difficult to develop credit programs and policies without this type of information.

Concluding Comments

Some of the participants in the Conference along with a number of other people who are interested in the operations of rural financial markets in low income countries are very concerned about the way these markets are functioning. In all too many countries these markets are doing little to encourage savings and capital formation. They are badly fragmented and doing a poor job of helping the economy to allocate real resources efficiently and equitably. Because of the widespread use of concessionary interest rates and the presense of ample inflation, these markets are also transferring very large income subsidies to those who receive negatively priced loans. High loan default rates, the lack of economies of scale in lending, and generally high loan transaction costs are all helping to undermine the financial integrity of many formal financial institutions. In my opinion, some significant and rather dramatic changes must be made in the way rural financial markets are used in the development process. This will include a number of changes in policies. We have to understand more clearly why financial markets fail to work in a socially desirable manner and to clearly identify the changes that are necessary for these markets to operate as they should.

The papers and discussion presented at the Conference led me to think that too much emphasis has been placed on the demand side of credit, and that too little emphasis has been placed on the supply side. Further, that too little attention has been given to using rural financial markets to mobilize voluntary savings. Further, credit has too often been viewed as an input in the production process and not as part of the financial intermediation process. Far too much attention has been directed at providing cheap credit to farmers and not enough attention paid to what low interest rates do to savers, the performance of financial institutions, efficient resource allocation, and income distribution. I also feel that more attention ought to be paid to how financial markets are used to satisfy political ends. It may be that we would understand a good bit more about how financial markets currently function if we analyzed whether cheap credit and toleration of loan defaults are part of a political patronage system.

During a reception before the Conference one of the Conference participants commented that he thought there was relatively little exciting to do in the way of analyzing rural financial markets. After listening to intense debate about the issues summarized above for three days and parts of several nights he was gracious enough to confess to me, at the end of the Conference, that he had changed his mind. He found a number of new and challenging topics raised in the Conference. I hope other readers of this volume will feel similarly stimulated.

LIST OF PAPERS PRESENTED AT THE CONFERENCE

Adams, Dale W, "Recent Performance of Rural Financial Markets in Low Income Countries," 26 p.

David, Cristina C. and Richard L. Meyer, "Measuring the Farm Level Impact of Agricultural Loans in Low Income Countries: A Review Article," 34 p.

D'Mello, L., "Institutional Aspects of Lending to Small Farmers -- The Indian Case," 40 p.

Dridi, Mohamed, "The Impact of a Public Agricultural Credit Program for Small Farmers, "The Special Fund for Developing Agriculture - FOSDA," 10 p.

Giorgis, Fana Wolde, "Agricultural Credit in Ethiopia," 9 p.

Graham, Douglas H. and Compton Bourne, "Agricultural Credit and Rural Development Strategies in Jamaica: A Development Dilemma," 38 p.

Harriss, Barbara, "Money and Commodities, Monopoly and Competition," 23 p.

Howell, John and Anthony Bottrall, "Credit Delivery and Institutional Choice in Small Farmer Development Programmes," 32 p.

Lipton, Michael, "Rural Credit, Farm Finance and Village Households," 28 p.

Osuntogun, Adeniyi, "Some Aspects of Farm Level Credit Use of a Sample of Cooperative Farmers in Oyo, Ogun and Ondo States of Nigeria," 17 p.

Roberts, Richard A. J., "Use of Applied Research and Training in Strengthening the Development of Credit Institutions," 15 p.

Stickley, Thomas and Edouard Tapsoba, "Loan Repayment Delinquency in the Eastern O.R.D. (Organisme Regional de Developement) of Upper Volta," 14 p.

Verhagen, Koenraad, "How to Promote People's Participation in Rural Development Through Local Organisations," 27 p.

Von Pischke, J. D., "The Political Economy of Specialized Farm Credit Institutions in Low-Income Countries," 27 p.

Wilson, Frank A., "The Non-Specialist Agency and Rural Credit: The Developing Role of Commercial Banks," 13 p.

Youngjohns, B. J., "Cooperatives and Credit - A Reexamination," 20 p.